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The U.S. Economy in 2002

I. Good afternoon. I'm delighted to be here to speak with you today.

  A. As President of the San Francisco Fed, my main focus, of course, is the conduct of monetary policy for the nation.

    1. When the Federal Open Market Committee meets to discuss the economy and the direction of policy, the other Fed Presidents and I also give our views on conditions in our Districts.

    2. Beyond this, the San Francisco Fed has a very active research program on economies in the Pacific Basin,

      a so this supports the contributions I make to the FOMC's discussion of developments in Asia.

  B. Today I'd like to share my views on all of these areas with you.

    1. I'll spend the bulk of my time on the U.S. economy.

    2. And I'll also touch on conditions in Asia and here in the Bay Area.

II. Of course, the economies of all of these areas—Asia, the U.S., and the Bay Area—are linked, to some degree.

  A. For example, they've all felt the pain of the collapse of the world technology market.

  B. As a major technology center in the U.S., the Bay Area has felt it especially hard.

    1. After very rapid growth in 1999 and 2000, the area economy scaled back substantially in 2001.

      a Employment fell by nearly 4 percent,

b and the unemployment rate rose from 2.3 percent to 5.9 percent.

2. Declining foreign demand for tech products is part of this story.

a Much of California's export base is high-tech products made in the Bay Area,

(1) and last year, California exports to East Asia fell substantially.

(2) In regard to Hong Kong, the state's exports began to drop a bit starting in the second quarter,

(a) and in the fourth quarter, the drop was precipitous.

b Mainland China was the exception.

(1) Their demand for California products grew strongly during most of last year, with only a slight drop in the fourth quarter.

C. Turning to Asia,

1. the emerging markets there have felt

a not only the effects of the tech bust,

b but also the slowdown of their major export markets,

(1) especially the U.S.

2. Hong Kong and Singapore were especially hard hit.

a Because both are small, open economies, they're quite dependent on exports.

(1) And the U.S. is a major export market for both countries, accounting for roughly one-fifth of the total.

b The high-tech bust has hurt worst in Singapore,

(1) as close to two-thirds of its manufactured exports are in the high tech area.

c Hong Kong, in contrast, has a somewhat more diversified export mix,

(1) with high-tech items accounting for about a fourth of manufactured exports.

3. This dependence on exports and on high-tech led to quite severe downturns in the latter half of last year.

a As a result, Hong Kong's growth for the whole of 2001 was zero,

b while for Singapore real GDP actually fell 2%.

c These numbers are among the worst for Asia.

4. Given the problems in the Japanese economy, Asian nations can't look to that country as an engine of growth.

a It's disappointing—to say the least—that the kinds of far-reaching reforms that have been hoped for have yet to materialize in Japan.

5. I can't talk about Asia without saying something about *mainland* China, where the picture is a good deal different.

a It has been less vulnerable to the global slowdown because

(1) overall, it's less dependent on exports,

(2) and it has a greater diversity of exports.

b In addition, China's economy has been boosted by

(1) continued fiscal stimulus

(2) and record inflows of foreign direct investment.

D. Looking ahead, I'd say that growth in Asia is likely to pick up again when the U.S. economy turns around.

III. Now, that naturally raises the question: "When *will* the U.S. economy turn around?"

A. Actually, most forecasters think we've begun to turn around *already*!

B. There's no question that the economy did better in the fourth quarter than expected.

1. Many analysts originally predicted real GDP would shrink at a rate of around 1 percent.

2. Instead, preliminary data indicate that real GDP advanced at nearly a 1-1/2 percent rate.

C. Besides overall real GDP growth, there are other signals that we may be on the upswing of the cycle.

D. One such signal is a drop in inventory investment.

1. Although it held real GDP growth down last year, especially toward the end of the year, it's actually good news going forward.

2. Businesses were able to pare unwanted inventories,

3. and that sets the stage for more production—and therefore real GDP growth—this year.

E. Another signal is that growth in real final sales recently has accelerated to a respectable rate, following weak performances in the recessionary second and third quarters.

1. This reflects strength in consumer spending,

a as auto sales surged in the fourth quarter, when people took advantage of extraordinary financing incentives.

b While some of the fourth quarter sales "borrowed" from sales that would have occurred in the current quarter,

(1) sales have held up well in recent months.

c Furthermore, we now have information about overall consumer spending in January,

(1) and it came in moderately strong.

F. A third signal is the improvement in business investment in equipment and software.

1. This category of spending has been going through a "correction" for more than a year, after several years of double-digit growth rates.

a The good news is that the rate of decline has slowed.

b So it's possible that the correction is nearing completion.

2. Furthermore, business investment in computers and related equipment showed a large increase in the fourth quarter—

a —the first since the fourth quarter of 2000.

b That suggests that the "tech bust"—which has been so difficult for Asia—may be turning around.

G. Finally, the data on productivity in the fourth quarter were *very* strong.

1. As we learned this morning, the productivity of businesses outside of farming surged at a 5.2 percent rate,

a bringing the increase to 2 percent for all of last year.

2. This is an especially impressive performance during a recession.

a It probably suggests that the process of technological innovation that spurred investment in the latter half of the 1990s is alive and well.

H. Now, aside from the numbers themselves, there are other reasons to look for the economy to be on the mend.

1. For one thing, there's stimulus coming from both monetary policy and fiscal policy.

a Last year, the Fed cut short-term interest rates substantially—

(1) —by four and three-quarters percentage points.

b On the fiscal side,

(1) the Congress passed two packages last year that will provide substantial stimulus this year.

2. For another, we seem to be getting a boost from last year's sharp declines in energy prices.

a With lower energy prices, households and businesses have more funds available to spend on other goods and services.

IV. Where does this leave us in terms of the outlook for this year?

A. Let me say a few words first about the Bay Area economy.

1. There *have* been some signs of improvement here lately, including

a a positive employment report for the month of January,

b and recent firming in residential real estate markets.

2. Still, the Bay Area recovery may lag the national recovery,

a as a solid pickup in technology spending probably is needed to jumpstart the local economy.

B. As for the national economy,

1. growth does seem to be on the rise.

a For example, the current quarter is very likely to be stronger than the previous quarter.

b For the whole of 2002, the FOMC's projection in late January was for a growth rate of 2-1/2 to 3 percent.

(1) And the data since then suggest that this range could be on the conservative side.

2. But there are still some downside risks.

a For example, we almost certainly face further increases in the unemployment rate,

(1) which was 5.6 percent in January,

(a) well above its low of around four percent in 2000.

(2) Higher unemployment could shake consumer confidence and slow spending in the near term.

b In addition, concerns are being raised about the reliability of corporate accounting.

(1) These concerns could further undermine equity values, which also could put a damper on spending.

V. So far I've talked about the outlook for this year. Let me conclude by turning to the long-run outlook, where I'm also optimistic—for a couple of reasons.

A. The first reason is that our economy has a resilient structure—

1. —financial markets are deregulated,

2. the banking system is sound,

3. and our labor markets are flexible.

4. These factors also help explain why the economy has been able to adjust relatively quickly to the kind of shock we suffered in September.

B. The second reason has to do with technology and the productivity of the American work force. And this applies with special significance to the Bay Area.

1. The kinds of technological advances that this area is renowned for and that propelled the national economy in the latter half of the 1990s are still in train.

a These developments operate on a long time scale,

b and they're not likely to be affected much by the kinds of cyclical developments we've been facing.

(1) And as I said earlier, productivity growth has been doing very well during the recession.

2. Moreover, the spirit of innovation and entrepreneurship in the Bay Area is alive and well.

3. The key point is that the outlook for productivity over the long haul continues to be bright,

a and this bodes well for our standard of living.

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